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SUBJECT: RUSSIAN COAL: PRODUCERS WAITING FOR SIGNS OF DEMAND

Classified By:
Econ Minister Counselor Eric Schultz; reasons 1.4 (b) and (d)

RUSSIAN COAL: PRODUCERS WAITING FOR SIGNS OF DEMAND

¶1. (C) Summary. Russian coking coal producers on 27 November appealed to the government for assistance as they grapple with unpaid bills owed to them by Russia's struggling steelmakers. Although coal producers' most immediate priority is to remain solvent in the face of their customers' non-payment, the prospects of demand collapsing are more worrying still, and producers are hoping government spending on steel-hungry infrastructure projects will help. Our contacts in the industry are preoccupied with understanding how much of the slumping demand is caused by the current market uncertainty and how much represents the new longer-term realities of the economy. The GOR's increasing willingness to provide direct support to parts of the real economy offers the sector some hope, but we expect that coal producers and the workers they employ are unlikely to escape mine closures and layoffs. End Summary.

Payment and Demand Problems

¶2. (C) Leading Russian coking coal producers Raspadskaya, Mechel, Belon, and Sibuglemet on 27 November sent a request for government relief to Deputy Prime Minister Igor Sechin, citing nearly $500 million in unpaid bills from their customers in the steel industry. That non-payment has emerged as a major concern -- despite the fact that nearly 70 percent of Russian coking coal production is wholly or partially owned by the large steel companies Evraz (which owns 40% of Raspadskaya), Mechel, and Severstal -- underscores the severity of the crisis's impact on the metallurgical sector. Non-payment threatens to exacerbate the downturn by leaving companies short of cash at a time when credit is all but unobtainable. For Raspadskaya, Russia's second-largest coking coal producer with some of the highest profit margins and lowest debt in the sector, non-payment is putting pressure on their immediate ability to pay their workers and their operating costs.

¶3. (C) However, Raspadskaya is looking to demand, not non-payment, to provide the true indicator of the severity of the crisis. Aleksandr Andreev, Raspadskaya's Deputy General Director for Strategic Planning told us on 13 November that they would not have a real sense of the depth of the crisis until February, when a new round of supply contract

negotiations would begin and give them more visibility on the prospects for demand. Slumping demand is also a key concern for Severstal, which has been insulated from the non-payment woes facing less-integrated companies by the fact that it is currently consuming all the coal it produces. "It all depends on how many cars people buy," Boris Granovskiy, the Strategy and Corporate Development Director for Severstal Resources -- Severstal's mining division -- told us in a 5 November meeting. Granovskiy noted that demand for cars in Russia had fallen only half as much as in the U.S., but he attributed this to the fact that Russians were still "spending like there's no crisis," in large part due to the government's skittishness about discussing the burgeoning economic problems.

¶4. (C) Granovskiy said he did not know what would happen to demand once the scale of the downturn became apparent and the GOR (and the media: "we don't exactly have a free media here," said Granovskiy sotto voce) frankly discussed the true state of affairs. He added that he was pessimistic about the length of time it would take for Russia to emerge from the current economic slump, noting that another key source of demand, construction, had all but stopped and estimating that it would take some three to five years for the economy to turn around.

Calls for Increased Government Spending

¶5. (C) Our sector contacts expressed frustration with the GOR's handling of the crisis to date, with particular frustration for the reluctance to address the state of Russia's real economy. "We hear that there's a recession in the U.S. -- and if there's a recession there, what do we have here?" asked Yuriy Malyshev, President of the Russian Mine Operators' association and of the Russian Academy of Mining Sciences in a mid-November meeting. "Our government isn't used to painful but necessary things," said Granovskiy. He noted that the government had focused its attention on liquidity, but that the liquidity was not flowing through because the banks were "trying to fix their own problems." "We cannot borrow any money at any rate, even though our balance sheet is good," he told us. He acknowledged, however, that if the government simply forced banks to start lending again "we would be right back in the same place we were."

¶6. (C) The solution proposed by our contacts was a hefty dose of government spending. Granovskiy felt the unaddressed problem was the lack of demand for consumer products -- so the government needed to spur that demand. He was hopeful for the vast levels of government spending that had lifted the U.S. out of the Great Depression, he said. "Investing in infrastructure would do a lot of good," he told us, by fighting unemployment and creating demand for steel and other products. Malyshev agreed, saying that if building projects -- whether construction projects or mine-improvement projects -- were being curtailed for lack of financing, the government should directly provide the credit to get work started again.

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Hoping for a Slowdown; Fearing Something Worse
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¶7. (C) Our contacts also expressed concern that the downturn in demand might be something more than a temporary burst of anxiety, as they had previously hoped. They are worried that the downturn might, in fact, be a prolonged one followed by lower growth. Granovskiy said he expected coal prices to decline significantly over the next three to five years. In response, Granovskiy said Severstal planned to hold off on all its development projects (most of which were overseas) save for those it had already launched, such as its acquisition of U.S. coal producer PBS Coal. In Russia, he noted that Severstal's coal operations were doing comparatively well but that this was because its steel operations were doing worse. The company was ordinarily

short coal, with internal coal production covering only half of the company's steel-making needs. Now, however, they were fully self-sufficient, a benefit at a time when coal prices had yet to fall as quickly as had prices for steel. Nonetheless, he said that Severstal did not expect much growth in its domestic operations and was planning to downsize its loss-making facilities.

¶8. (C) Andreev also expected demand in Russia to be weaker in the long term. He said the company was looking to cut costs, such as putting off geological work and other longer-term projects. Andreev stated that Raspadskaya was not planning to fire anyone just yet, but had moved to shorter workweeks in response to current market conditions. The company planned to put off making any "real" decisions about its operations, including lay-offs, until February, when it would take stock of the market. Andreev said that although the company feared weaker long-term demand, it wanted to make good decisions on what operations to maintain in order to position itself for the upturn when it came.

Some Mines Likely to Close

¶9. (C) Malyshev told us he had a bleak outlook on the sector,s immediate future. He specifically noted Raspadskaya's shortened workweeks. Raspadskaya's major mine is the most modern in Russia, he said, having recently undergone a massive capital expenditure program. If this mine, with its cutting-edge technology and low costs, had to cut back on working hours, then the many mines throughout Russia with older technology and higher technology were likely to face major layoffs or even closures.

¶10. (C) Severstal's Granovskiy had a similar take. The outlook for Severstal's coal-mining competitors was "not positive," he said, but it was still "less negative" for vertically-integrated companies like Severstal. Granovskiy said matter-of-factly that if a non-integrated coking coal mine lacked low costs and high quality coal it would have to close. (Note: Coal, like oil, comes in a range of qualities whose price increases with its quality. Much of Russia's coal -- again, like its oil -- has many impurities and falls at the lower end of the spectrum. End note.)

Comment

¶11. (C) We expect coal producers and the workers they employ will not be able to escape some mine closures and layoffs. The GOR's increased willingness to provide direct support to parts of the real economy offers some hope. Certainly, government assistance could help coal producers weather the downturn as they struggle to pay their bills, and an infrastructure boom could kick-start demand. However, analysts had forecast problems in the sector even before the financial crisis hit and many of Russia's mines were barely staying afloat when the market was thriving. The key variables in determining the extent of the closures and layoffs will be not just the efficacy of the GOR's response but, more importantly, the companies' ability to use the grace period it provides to implement improved strategies.
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